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Memorandum

TO: BATA Authority

DATE: February 28, 2008

FR: Executive Director

RE: Resolution No. 77 – Approval of Refunding Bonds

Staff recommends approval of Resolution No. 77 authorizing the issuance of up to \$1.2 billion in toll revenue refunding bonds, authorizing the purchase of bonds to be refunded, and authorizing the restructuring of related swaps if necessary.

Background

Since 2001 BATA has issued a total of \$5.4 billion in toll and revenue backed debt consisting of 54% floating rate and 46% fixed rate debt. Two insurers, Ambac and XL Capital, guarantee payment on the floating rate debt. The insurance guarantee was supported by the firm's Aaa/AAA/AAA credit ratings.

Since December, the credit strength of the AAA insurance companies has been in serious question. As a result of insuring securities linked to subprime mortgages, Ambac has lost its AAA ratings from Fitch (down to AA) and XL Capital has been downgraded from Aaa/AAA/AAA (Moody's, Standard & Poors, and Fitch) to A3/A-/AA. Both firms remain on "Negative Outlook" with all three rating agencies.

BATA has two types of insured variable rate bonds, Auction Rate Securities (ARS) and Variable Rate Demand Obligation (VRDO). In the event of a BATA default, the payment of interest and principal when due on both types of bonds is guaranteed by the insurer. The two differ as to how interest rates are set and bondholders are assured they can sell their bonds. ARS are long-term bonds with rates set through a weekly auction process and without any assurance that bondholders can sell their bonds at par. The broker-dealers for the VRDO bonds set rates daily or weekly and bondholders are assured that they can sell their bonds at par through a bank standby arrangement. The perceived weakness of the insurance guarantee has limited the market for both types of tax-exempt debt and driven interest rates through normal tax-exempt benchmarks and often above taxable rates.

Recent actions by the insurers indicate that a workout strategy or resolution of credit questions may be some time off. In the interim, there is little evidence to indicate that variable rate interest costs will go back to normal. In fact, recent transactions indicate that the bondholders are now pricing premiums into their portfolios by purchasing the highest rated bonds with the highest allowable remarketing default rate.

Bank Liquidity Contracts

The first step in trying to stabilize the bulk of the VRDO portfolio does not involve financing at all, but involves a modification to the contract provisions that are controlling the remarketing of the bonds, regardless of their rating. Negotiations to modify the agreement started with the bank agent over a month ago. By renegotiating the existing bank agreements, it may be possible to remove the insurer

related credit issues, potentially allowing the VRDO bonds to trade at attractive tax exempt rates again based on BATA's credit. Unfortunately, this option only works for the \$2 billion in Ambac insured bonds whose ratings remain above the minimum A3 level required for money market eligibility. While this option may make it possible to preserve the Ambac insurance policy, it will likely also significantly increase bank fees and charges. BATA can expect these costs to at least double, increasing by approximately \$4 million annually.

In addition to renegotiating the bank remarketing agreements, there are four basic strategies we can apply to the current variable rate credit crisis:

1. Do nothing
Wait for the market to straighten out. At current index rates, and assuming no further degradation of the Ambac bonds, the additional interest cost will be \$2.3 million per month.
2. Refinance XL Capital Bonds – \$500 million
The XL VRDO issue is the most immediate problem. The A3/A- ratings mean that XL bonds are no longer eligible investments for most tax-exempt money market funds. Since money market funds are the largest purchasers of variable rate debt, the limited market is driving interest rates up on all insured VRDO bonds. Given the overall credit problems XL is having, neither the VRDO nor ARS are expected to recover.
3. Refinance XL Capital VRDO and all of the Auction Rate Bonds – \$1 billion
The ARS portfolio also suffers from insurer doubts with costs almost as high as the XL VRDO bonds. Unless the market corrects itself, refinancing these bonds is the only way to lower interest costs to a rate much closer to the tax-exempt index of 3.10%.
4. Refinance entire variable portfolio – \$3 billion
We are experiencing higher costs on the entire \$3 billion variable rate portfolio on both XL and Ambac insured bonds. While the XL impact is more immediate, a sudden Ambac downgrade could expose the Authority to higher rates on an additional \$2 billion in debt. If the bank document modifications do not ease the investor concerns, BATA may still have to deal with restructuring the entire variable rate portfolio.

At this point, staff is recommending option no. 3 – refinance the ARS bonds and the XL-insured VRDO bonds. The recommended steps to implement option no. 3 include:

- Take immediate steps to commit to retire XL Capital Demand Bonds – \$290 million
Announce that BATA will purchase the bonds within 120 days. The offer to purchase should stop the interest rate spike and after purchasing the bonds, BATA has 90 days to complete the remarketing or refunding of the bonds on a long term basis.
- Change the interest mode on the Auction Rate Bonds – \$720 million
By changing the interest mode or auction period on the ARS from weekly to six months, BATA will effectively “park” the bonds out of the weekly market. Parking the ARS bonds will have two benefits. First, we believe that our broker-dealers and their customers will purchase and hold the bonds for six months at rates from 2.50% to 2.70%, (well below the current weekly rate of 4.70%). Second, BATA will have up to six months to complete the remarketing or refunding of the bonds. BATA may also purchase the bonds for later resale which would also have the effect of “parking” the bonds and reducing interest costs.

- Complete refinancing the XL Capital VRDO and all Auction Rate Bonds – \$1 billion
Unless the market improves for XL Capital VRDO or auction rate bonds, BATA will have to refinance that variable rate debt to remove the credit issues. The first step would be to refinance the bonds with the highest interest rates, the \$290 million XL Capital Variable Rate Demand Bonds and then all of the Auction Rate Bonds. The bonds will be refinanced in an uninsured variable rate mode.

While these steps should resolve the credit issues on \$1 billion of the current debt portfolio, these steps do not address any further degradation of Ambac insured bonds if the change in bank documents does not work. Staff will work out contingency plans and bring them to the Board should it become necessary.

Recent Changes

- A meeting with our bank liquidity agent on February 27th indicated that there is now enough new bank capacity to do the entire \$720 million ARS refinancing on a variable rate basis. This commitment of new capacity (the XL VRDO already have liquidity) allows us to make a more refined and structured financing recommendation.
- Rather than authorize a combination of fixed and variable rate bonds based on available bank capacity, we recommend eliminating the possibility of a fixed component and doing the entire transaction on a variable rate basis.
- Because we are not recommending fixed rate debt, the swap agreements in place may not be affected. As such, we not recommending any new swap authority. We are, however, requesting flexibility to renegotiate existing swaps should it become necessary, but within existing swap parameters.

Resolution No. 77

Resolution No. 77 has been revised from the version you reviewed at the last Authority meeting to reflect the recent changes to our refinancing strategy described above. Both an underlined/strikeout version and a clean copy of the new Resolution are attached. Resolution No. 77 authorizes the steps necessary to complete refunding the XL Capital VRDO and all the ARS bonds. The bonds will be issued on a variable rate basis. The plan is to issue new uninsured variable rate bonds to replace the current insured bonds. The Resolution authorizes the following:

- Issuing up to \$1.2 Billion in Refunding Bonds
The \$1.2 billion includes:

XL Capital VRDO and ARS	\$ 1,010 million
Debt Service Reserve	120 million
Cost of Issuance (1.25%)	15 million
Credit Enhancement	35 million
Miscellaneous	<u>20 million</u>
Not-to-Exceed Issuance	<u>\$ 1,200 million</u>
Not-to-Exceed Term	40 Years

- Purchase or Retire Bonds
This will allow BATA to potentially purchase the bonds to be refunded before they are “put” to the liquidity bank and “park” the bonds until they can be refinanced. BATA may also issue a “tender” notice informing the bondholders of our intent to retire the bonds by a specific date.
- Executing or Amending New Liquidity Agreements
BATA will attempt to renegotiate agreements in order to restore the variable rate bonds to their normal tax-exempt trading range.
- Negotiate New or Amend Existing Agreements
A number of existing documents from insurance to remarketing will be affected by the potential refinancing. This provision authorizes new agreements as necessary to carry out the refinancing.

The one remaining approval will be the Offering Document and Official Statement which will be presented to the Authority at your April meeting. Staff is requesting approval of Resolution No. 77.

/Steve Heminger/
Steve Heminger

SH/BY/cj